Federal Accounting Standards Advisory Board

# Interpretation

# Items Held for Remanufacture

## Exposure Draft

Written comments are requested by October 16, 2006

## THE FEDERAL ACCOUNTING STANDARDS ADVISORY BOARD

The Secretary of the Treasury, the Director of the Office of Management and Budget (OMB), and the Comptroller General, established the Federal Accounting Standards Advisory Board (FASAB or "the Board) in October 1990. FASAB is responsible for promulgating accounting standards for the United States Government. These standards are recognized as generally accepted accounting principles (GAAP) for the Federal Government.

An accounting standard is typically formulated initially as a proposal after considering the financial and budgetary information needs of citizens (including the news media, state and local legislators, analysts from private firms, academe, and elsewhere), Congress, Federal executives, Federal program managers, and other users of Federal financial information. The proposed standards are published in an Exposure Draft for public comment. In some cases, a discussion memorandum, invitation for comment, or preliminary views document may be published before an exposure draft is published on a specific topic. A public hearing is sometimes held to receive oral comments in additional to written comments. The Board considers comments and decides whether to adopt the proposed standard with or without modification. After review by the three officials who sponsor FASAB, the Board publishes adopted standards in a Statement of Federal Financial Accounting Standards. The Board follows a similar process for Statement of Federal Financial Accounting Concepts, which guide the Board in developing accounting standards and formulating the framework for Federal accounting and reporting.

Additional background information is available from the FASAB or its website:

- "Memorandum of Understanding among the General Accounting Office, the Department of the Treasury, and the Office of Management and Budget, on Federal Government Accounting Standards and a Federal Accounting Standards Advisory Board."

- "Mission Statement: Federal Accounting Standards Advisory Board", Exposure drafts, Statements of Federal Financial Accounting Standards and Concepts, FASAB newsletters, and other items of interest are posted on FASAB's website at: www.fasab.gov.

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Federal Accounting Standards Advisory Board

August 1, 2006

TO: HEADS OF FEDERAL AGENCIES AND ALL OTHERS WHO USE, PREPARE, AND AUDIT FEDERAL FINANCIAL INFORMATION

The Federal Accounting Standards Advisory Board (FASAB or the Board) is requesting comments on the exposure draft of a proposed Interpretation entitled, Items Held for Remanufacture. Your response would be more helpful to the Board if you explain the reasons for your position and any alternative you propose. Responses are requested by October 16, 2006.

We have experienced delays in mail delivery due to increased screening procedures. Therefore, please provide your comments in electronic form. Responses in electronic form should be sent by e-mail to comesw@fasab.gov. If you are unable to provide electronic delivery, we urge you to fax the comments to (202) 512-7366. Please follow up by mailing your comments to:

Wendy M. Comes, Executive Director
Federal Accounting Standards Advisory Board
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The Board's rules of procedure provide that it may hold one or more public hearings on any exposure draft. No hearing has yet been scheduled for this exposure draft.

Notice of the date and location of any public hearing on this document will be published in the Federal Register and in the FASAB's newsletter.

David Mosso
Chairman

# Executive Summary

### What is the Board Proposing?

The Board is proposing guidance for classification, valuation and reporting of items that are held for remanufacture prior to sale or issuance.

### Why is the Board making this Proposal?

The Department of Defense (DoD) requested the Board's guidance for items held for remanufacture, which represent a significant portion of the DoD's assets. This guidance would apply to other Federal entities with items that are held for remanufacture prior to sale or issuance.

### How would this proposal improve federal financial reporting?

This proposal would provide guidance for categories of assets that are significant on a government-wide basis, but are not specifically addressed in existing standards.

### How would this proposal contribute to meeting the federal financial reporting objectives?

This proposal would clarify the application of existing standards to a significant category of assets of the federal government.

## Table of Contents

## Request for Comments

Specific questions are posed. Respondents may offer responses to the specific questions, raise new issues, or respond generally. It is most helpful if your responses include an explanation for your position and any alternatives you propose. Note that all responses received will be publicly available on the FASAB website and at the FASAB offices. A Word version of these questions is available at www.fasab.gov/exposure.html.

**Q1.** This proposed Interpretation would apply to items in the process of inspection, disassembly, evaluation, cleaning, rebuilding, refurbishing and restoration to serviceable or technologically updated/upgraded condition. **Does this description adequately describe the scope of this proposed Interpretation?**

**Q2.** The proposed Interpretation explains that the intent of paragraphs 17-25 and 32-34 of Statement of Federal Financial Accounting Standards (SFFAS) 3 is that inventory held for repair should be valued at less than the value of a new or serviceable item, and that as the work on the item progresses, the value of the item should be increased accordingly. The proposed Interpretation states that inventory items held for remanufacture that are intended for sale may be valued in accordance with either the allowance method or the direct method described in paragraphs 32-33 of SFFAS 3 or the historical production cost described in paragraphs 20-22 of SFFAS 3. (Paragraph 6 of this exposure draft provides examples.) **Do you agree that any of the three methods of valuation would achieve the above objective?**

**Q3.** The proposed Interpretation states that items held for remanufacture that meet the definition of property, plant and equipment should be recognized as a category of Property, Plant and Equipment and should be valued in accordance with SFFAS 6 as amended and provides examples. (See paragraphs 12-17 of this exposure draft) **Do you agree that this valuation is appropriate?**

**Q4.** The proposed Interpretation addresses equipment components that are rotated in and out of service and states that the composite or group methodology[1] can reasonably be applied to an entire class of such items. **Do you agree that this methodology is appropriate?**

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[1] The composite methodology is a method of calculating depreciation that applies a single average rate to a number of heterogeneous assets that have dissimilar characteristics and service lives. The group methodology is a method of calculating depreciations that applies a single, average rate to a number of homogeneous assets having similar characteristics and service lives. (SFFAS 23, footnote to paragraph 9)

**Q5.** The proposed interpretation states that items held for remanufacture that meet the definition of Operating Materials and Supplies should be recognized as a category of Operating Materials and Supplies and valued in accordance with paragraphs 42-44 of SFFAS 3 and provides examples. (See paragraphs 18-19 of this exposure draft.) **Do you agree with the proposed accounting treatment for this category of items?**

# Introduction

## Purpose

1. Current standards do not provide specific guidance to assist preparers and auditors in the classification, valuation and reporting of items that are in the process of major overhaul or remanufacture for sale or for internal use. This proposed Interpretation would identify acceptable options for classification, valuation and reporting by applying existing standards, in particular Statements of Federal Financial Accounting Standards (SFFAS) 3, *Accounting for Inventory and Related Property*, and SFFAS 6, *Accounting for Property, Plant and Equipment*.

## Scope

2. This proposed Interpretation would apply to reparable parts and subassemblies that are in the process of inspection, disassembly, evaluation, cleaning, rebuilding, refurbishing and restoration to serviceable or technologically updated/upgraded condition. This Interpretation would address remanufacturing activity for items intended for sale or for internal use. Items held for remanufacture consist of direct materials (including repairable parts and subassemblies, also referred to as "carcasses" at the Department of Defense (DoD), and work-in-process where products are restored to serviceable condition and/or improved/upgraded condition for sale or internal use.

## Exclusion

3. This proposed Interpretation does not apply to stand-alone items such as entire airplanes, ships, tanks, intercontinental ballistic missiles (ICBMs) or other higher assemblies that function independently.

## Materiality

4. The provisions of this Interpretation need not be applied to immaterial items.

## Effective Date

5. This Interpretation would be effective upon issuance.

## Proposed Interpretation

### Definitions

6. Items "**held for remanufacture**[2]" are in the process of inspection, disassembly, evaluation, cleaning, rebuilding, refurbishing and restoration to serviceable or technologically updated/upgraded condition. Items held for remanufacture consist of:
   - Direct materials, (including repairable parts or subassemblies, also referred to as "carcasses" at the DoD) and
   - Work-in-process (including labor costs) related to the process of major overhaul, where products are restored to "good-as-new" condition and/or improved/upgraded condition.

7. "Items held for remanufacture" share characteristics with "items held for repair" and items in the process of production and may be aggregated with either class.

8. Items held for remanufacture may be intended for sale (placed in **inventory** held for sale upon completion of remanufacture) or for internal use (issued to a user within the same reporting entity upon completion of remanufacture).

### Recognition and Measurement

<u>Items Intended for Sale (Inventory)</u>

9. Inventory items intended for sale that are held for remanufacture may be valued in accordance with either paragraphs 32-33 of SFFAS 3 or paragraphs 20-22 of SFFAS 3.[3] For example, paragraph 21 states that "Historical cost shall include all appropriate purchase, transportation and production costs incurred to bring the items to their current condition and location." Applied to reparable parts and subassemblies returned for credit in the purchase of a serviceable item, historical cost would be the credit, if any, issued to the customer who returned the item to be repaired and any identifiable and chargeable transportation and handling costs. Regardless of the method used, reparable items returned by customers should be valued at less than the value of new or fully remanufactured items with similar features and useful lives. As the inspection and remanufacture process takes place, appropriate "production costs" would include normal costs to bring the item to serviceable or upgraded condition.

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[2] Terms appearing for the first time in bold are defined in the Glossary, Appendix D of this document.
[3] The paragraphs in SFFAS 3 and 6 cited above are displayed in Appendix C of this document.

10. "Abnormal costs" to be excluded would include any costs that are in excess of the cost to purchase and place in service a new item with similar features and useful life. For items that are no longer available on the open market, or which are being upgraded, management should use judgment in determining normal and reasonable costs to be capitalized.

11. Inventory items held for remanufacture share characteristics with inventory held for repair and items in production for sale (direct materials and work-in process) and may be aggregated with either class of items for reporting purposes.

Items Not Intended for Sale (Property, Plant and Equipment and Operating Materials and Supplies)

Property, Plant and Equipment

12. Parts and subassemblies held for remanufacture that are intended for use, rather than for sale, and which meet the definition of **Property, Plant and Equipment**[4], should be recognized as a category in Property, Plant and Equipment and should be valued in accordance with SFFAS 6, as amended. Paragraph 26 of SFFAS 6 describes types of costs to be capitalized and provides examples.

13. When an item is undergoing a major remanufacture that will either extend its useful life or improve its capacity, costs should be capitalized in accordance with paragraph 37 of SFFAS 6.

14. Parts and subassemblies held for remanufacture that meet the definition of Property, Plant and Equipment should be valued at less than the value of new or fully remanufactured items. As the inspection and remanufacture process takes place, appropriate "production costs" would include normal costs to bring the item to serviceable or upgraded condition. Abnormal costs to be excluded would include any costs in excess of the cost to obtain and place in service a new item with similar features and useful life.

[4] See SFFAS 6, paragraph 17.

Selection of Depreciation Methods

15. SFFAS 6 allows flexibility in determining the “base unit” for accounting purposes such as depreciation.[5]

16. The composite method of depreciation is a method of calculating depreciation that applies a single average rate to a number of heterogeneous assets that have dissimilar characteristics and service lives. The group methodology is a method of calculating depreciation that applies a single, average rate to a number of homogeneous assets having similar characteristics and service lives. A composite or group methodology, whereby the costs of PP&E are allocated using the same allocation rate, is permissible.[6]

17. For classes of parts and subassemblies such as motors and engines that flow in and out of use, management should determine whether to calculate depreciation on the entire major classes of such items, or whether the population of items that are not in service should be separately identified and not depreciated.

Operating Materials and Supplies

18. Items held for remanufacture that meet the definition of **Operating Materials and Supplies**, if significant, may be recognized as a category of operating materials and supplies and valued in accordance with paragraphs 42-44 of SFFAS 3.

19. Items held for remanufacture that meet the definition of Operating Materials and Supplies should be valued at less than the value of new or fully remanufactured items. As the inspection and remanufacture process takes place, appropriate “production costs” would include normal costs to bring the item to serviceable or upgraded condition. Abnormal costs to be excluded would include any costs in excess of the cost to obtain and place in service a new item with similar features and useful life.

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[5] See SFFAS 6, paragraph 22 and related footnote.

[6] See SFFAS 23, paragraph 9(f) and related footnote.

### Disclosure Requirements

Component Entity Report Disclosures

20. The disclosures for inventory items held for remanufacture should conform with paragraph 35 of SFFAS 3.

21. The disclosures for items held for remanufacture that meet the definition of property, plant and equipment should be in accordance with the requirements of paragraph 45 of SFFAS 6.

22. The disclosures for items held for remanufacture that meet the definition of Operating Materials and Supplies should be in accordance with the requirements of paragraph 50 of SFFAS 3. If significant, Operating Materials and Supplies held for remanufacture may be disclosed as a separate category.

Financial Report of the U.S. Government Disclosures

23. For the Financial Report of the U.S. Government, there is no provision for valuation or recognition that is different from requirements for the component level.

The provisions of this Statement need not be applied to immaterial items.

## Appendix A: Basis for Conclusions

This appendix discusses some factors considered significant by members in reaching the conclusions in this proposed Interpretation. It includes reasons for accepting certain approaches and rejecting others. Individual members gave greater weight to some factors than to others.

### Project History

A1. Accounting for the federal government's physical assets that are held as inventory or as property, plant and equipment is complex and has been addressed in numerous FASAB Standards.[7] The Board continues to address issues as they arise. In March of 2006, the Department of Defense (DoD) Deputy Chief Financial Officer sent a letter to the Board (see Appendix D) requesting specific guidance for items held for remanufacture.

A2. The DoD requested that SFFAS 3 be amended to provide standards for inventory held for remanufacture. The DoD noted that the category of inventory "held for repair" is not defined in the standards, and that the valuation methods for "held for repair" in paragraphs 32-34 of SFFAS 3 are not cost effective to apply to items held for remanufacture within the moving average cost method, since the moving average cost of a serviceable item changes continually.

### Definition and Exclusions

A3. This Interpretation is limited to reparable parts and subassemblies, which are not specifically addressed in current standards, and for which guidance has been requested by the DoD. This Interpretation does not apply to stand-alone items that function independently; such as entire airplanes, ships, tanks, ICBMs and other stand-alone items. Such items are already addressed in SFFAS 3 and SFFAS 6, as amended.

### Inventory Valuation

A4. SFFAS 3 provides basic principles of inventory valuation applicable to both inventory in the process of production for sale and held for repair:

- Historical cost valuation is to be applied to inventory (SFFAS 3, paragraphs 20, 32, 33 and 42),

[7] Inventory: see SFFAS 3; Property Plant & Equipment: see SFFAS 6, amended by SFFAS 10, 14, 16 and 23.

- Historical cost includes all appropriate purchase, transportation and production costs incurred to bring the items to their current condition and location, (SFFAS 3, paragraphs 21 and 43) and
- Abnormal costs should be expensed when incurred (SFFAS 3, paragraphs 21 and 43).

A5. Given the common objectives described above for the two categories and the absence of clear distinctions between the two categories, the Board does not believe that an amendment is needed. The Board believes that in some circumstances the only thing that distinguishes the remanufacturing process from the production process is that the raw materials include items previously in service.

A6. The Board believes that the intent of paragraphs 17-34 of SFFAS 3 is that an item held for remanufacture should be valued at less than the value of a new or serviceable item, and that as the work on the item progresses, the value of the item should be increased accordingly. The Board believes that any of the three methods (the allowance method or the direct method, described in paragraphs 32-33 of SFFAS 3 or the historical production cost method described in paragraphs 21 and 43 of SFFAS 3) would provide results that would meet this objective.

Operating Materials and Supplies Held for Repair

A7. SFFAS 3 did not anticipate the existence of a significant category of Operating Materials and Supplies held for repair or remanufacture. For example, reparable parts and subassemblies related to tactical munitions may meet the definition of Operating Materials and Supplies. The Board believes that historical cost may be reasonably applied in a manner similar to that of inventory held for repair.

<u>Property, Plant and Equipment Held for Remanufacture</u>

A8. The Board believes that in the production of Property, Plant and Equipment items, as in inventory production, in some circumstances the only thing that distinguishes the remanufacturing process from the production process is that the raw materials include reparable parts and subassemblies previously in service. The Board believes that the valuation and reporting requirements of paragraphs 26-44 of SFFAS 6, as amended, can reasonably be applied to items held for remanufacture.

A9. The Board also believes that the group or composite methods of depreciation defined in SFFAS 23[8] can be reasonably applied to an entire category of reparable parts and subassemblies. As in private industry, ease of application is an important

[8] See SFFAS 23, paragraph 9(f) and related footnote.

characteristic in management's decision whether to apply depreciation to groups of assets or to individual assets.[9]

Effective Date

A10. Interpretations do not have an effective date, as they carry the effective dates of the standard(s) being interpreted

[9] For example, see American Institute of Certified Public Accountants Industry Guide for Airlines, May 1, 2003, Section 3.104.

## Appendix B: Glossary

**Composite Method of Depreciation** - The composite methodology is a method of calculating depreciation that applies a single average rate to a number of heterogeneous assets that have dissimilar characteristics and service lives

**Group Method of Depreciation** - The group methodology is a method of calculating depreciation that applies a single, average rate to a number of homogeneous assets having similar characteristics and service lives

**Held for Remanufacture** – Items in the process of inspection, disassembly, evaluation, cleaning, rebuilding, refurbishing and restoration to serviceable or technologically updated/upgraded condition. Items held for remanufacture consist of direct materials, (including repairable parts and subassemblies, also referred to as "carcasses" at the Department of Defense) and work-in-process (including labor costs).

**Inventory** – Inventory is tangible personal property that is (1) held for sale, (2) in the process of production for sale, or (3) to be consumed in the production of goods for sale or in the provision of services for a fee.

**Operating Materials and Supplies** – Operating Materials and Supplies consist of tangible personal property to be consumed in normal operations. Excluded are:
(1) goods that have been acquired for use in constructing real property or in assembling equipment to be used by the entity, (2) stockpile materials, (3) goods held under price stabilization programs, (4) foreclosed property, (5) seized and forfeited property, and (6) inventory.

**Property, Plant and Equipment** –Property, Plant and Equipment consists of tangible assets, including land, that meet the following criteria:

- they have estimated useful lives[10] of two years or more;
- they are not intended for sale in the ordinary course of operations; and
- they have been acquired or constructed with the intention of being used, or being available for use by the entity.

[10] Useful life is the normal operating life in terms of utility to the owner. (Adapted from *Kohler's Dictionary for Accountants*) See SFFAS 6, paragraph 17.

## Appendix C: Relevant Citations of Current Standards

# SFFAS 3, *Accounting for Inventory and Related Property*

[20] ***Valuation.*** Inventory shall be valued at either (1) historical cost or (2) latest acquisition cost.

[21] (1) Historical cost shall include all appropriate purchase, transportation and production costs incurred to bring the items to their current condition and location. Any abnormal costs, such as excessive handling or rework costs, shall be charged to operations of the period. Donated inventory shall be valued at its fair value at the time of donation. Inventory acquired through exchange of nonmonetary assets (e.g., barter) shall be valued at the fair value of the asset received at the time of the exchange. Any difference between the recorded amount of the asset surrendered and the fair value of the asset received shall be recognized as a gain or a loss.

[22] The first-in, first-out (FIFO); weighted average; or moving average cost flow assumptions may be applied in arriving at the historical cost of ending inventory and cost of goods sold. In addition, any other valuation method may be used if the results reasonably approximate those of one of the above historical cost methods (e.g., a standard cost system).

[32] ***Inventory Held for Repair.*** Inventory held for repair may be treated in one of two ways: (1) the allowance method or (2) the direct method.

(1) Under the allowance method, inventory held for repair shall be valued at the same value as a serviceable item. However, an allowance for repairs contra-asset account (i.e., repair allowance) shall be established. The annual (or other period) credit(s) required to bring the repair allowance to the current estimated cost of repairs shall be recognized as current period operating expenses. As the repairs are made the cost of repairs shall be charged (debited) to the allowance for repairs account.

[33] (2) Under the direct method, inventory held for repair shall be valued at the same value as a serviceable item less the estimated repair costs. When the repair is actually made, the cost of the repair shall be capitalized in the inventory account up to the value of a serviceable item. Any difference between the initial estimated repair cost and the actual repair cost shall be either debited or credited to the repair expense account.

[35] ***Disclosure Requirements.***

- General composition of inventory.
- Basis for determining inventory values; including the valuation method and any cost flow assumptions.
- Changes from prior year's accounting methods; if any.
- Balances for each of the following categories of inventory: inventory held for current sale, inventory held in reserve for future sale, excess, obsolete and unserviceable inventory, and inventory held for repair unless otherwise presented on the financial statements.
- Restrictions on the sale of material.
- The decision criteria for identifying the category to which inventory is assigned.
- Changes in the criteria for identifying the category to which inventory is assigned.
- A composite or group depreciation methodology[11], whereby the costs of PP&E are allocated using the same allocation rate, is permissible.

**Operating Materials and Supplies**

[11] The composite methodology is a method of calculating depreciation that applies a single average rate to a number of heterogeneous assets that have dissimilar characteristics and service lives. The group methodology is a method of calculating depreciations that applies a single, average rate to a number of homogeneous assets having similar characteristics and service lives.

[36] ***Definition.*** "Operating materials and supplies" consist of tangible personal property to be consumed in normal operations. Excluded are (1) goods that have been acquired for use in constructing real property or in assembling equipment to be used by the entity, (2) stockpile materials, (3) goods held under price stabilization programs, (4) foreclosed property, (5) seized and forfeited property, and (6) inventory.

[37] Operating materials and supplies shall be categorized as (1) operating materials and supplies held for use, (2) operating materials and supplies held in reserve for future use, or (3) excess, obsolete and unserviceable operating materials and supplies. These categories are defined in paragraphs 36, 45, and 47 respectively.

[38] ***Recognition.*** The consumption method of accounting for the recognition of expenses shall be applied for operating materials and supplies. Operating materials and supplies shall be recognized and reported as assets when produced or purchased. "Purchased" is defined as when title passes to the purchasing entity. If the contract between the buyer and the seller is silent regarding passage of title, title is assumed to pass upon delivery of the goods. Delivery or constructive delivery shall be based on the terms of the contract regarding shipping and/or delivery.

[39] The cost of goods shall be removed from operating materials and supplies (i.e., the asset account) and reported as an operating expense in the period they are issued to an end user for consumption in normal operations.

[40] If (1) operating materials and supplies are not significant amounts, (2) they are in the hands of the end user for use in normal operations, or (3) it is not cost-beneficial to apply the consumption method of accounting, then the purchases method may be applied to operating materials and supplies. The purchases method provides that operating materials and supplies be expensed when purchased.

[41] An end user is any component of a reporting entity that obtains goods for direct use in the component's normal operations. Any component of a reporting entity, including contractors, that maintains or stocks operating materials and supplies for future issuance shall **not** be considered an end user.

[42] ***Valuation Under the Consumption Method.*** Operating materials and supplies shall be valued on the basis of historical cost.

[43] Historical cost shall include all appropriate purchase and production costs incurred to bring the items to their current condition and location. Any abnormal costs, such as excessive handling or rework costs, shall be charged to operations of the period. Donated operating materials and supplies shall be valued at their fair value at the time of donation. Operating materials and supplies acquired through exchange of nonmonetary assets (e.g., barter) shall be valued at the fair value of the asset received at the time of the exchange. Any difference between the recorded amount of the asset surrendered and the fair value of the asset received shall be recognized as a gain or a loss.

[44] The first-in, first-out (FIFO); weighted average; or moving average cost flow assumptions shall be applied in arriving at the historical cost of ending operating materials and supplies and cost of goods consumed. In addition, any other valuation method may be used if the results reasonably approximate those of one of the above historical cost methods (e.g., a standard cost or latest acquisition cost system).

## SFFAS 6, *Accounting for Property, Plant and Equipment,* as amended

[17] Property, plant and equipment consists of tangible assets, including land, that meet the following criteria:

- they have estimated useful lives[12] of 2 years or more;
- they are not intended for sale in the ordinary course of operations; and
- they have been acquired or constructed with the intention of being used, or being available for use by the entity.

[26] **All general PP&E** shall be recorded at cost. Cost shall include all costs incurred to bring the PP&E to a form and location suitable for its intended use. For example, the cost of acquiring property, plant, and equipment may include:

- amounts paid to vendors;
- transportation charges to the point of initial use;
- handling and storage costs;
- labor and other direct or indirect production costs (for assets produced or constructed);
- engineering, architectural, and other outside services for designs, plans, specifications, and surveys;
- acquisition and preparation costs of buildings and other facilities;
- an appropriate share of the cost of the equipment and facilities used in construction work;
- fixed equipment and related installation costs required for activities in a building or facility;
- direct costs of inspection, supervision, and administration of construction contracts and construction work;
- legal and recording fees and damage claims;
- fair value of facilities and equipment donated to the government; and
- material amounts of interest costs paid.[13]

[27] [See SFFAS 10 for standards for internally-developed software.]

[28] [See SFFAS 10 for standards for internally-developed software.]

[29] The cost of general PP&E acquired under a **capital lease** shall be equal to the amount recognized as a liability for the capital lease at its inception (i.e., the net present value of the lease payments calculated as specified in the liability standard[14] unless the net present value exceeds the fair value of the asset).

[30] The cost of general PP&E acquired through **donation, devise,[15] or judicial process** excluding forfeiture (See paragraph 33) shall be estimated fair value at the time acquired by the government.

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[12] Useful life is the normal operating life in terms of utility to the owner. (Adapted from *Kohler's Dictionary for Accountants*) See SFFAS 6, paragraph 17.

13 "Interest costs" refers to any interest paid by the reporting entity directly to providers of goods or services related to the acquisition or construction of PP&E.

14 See Statement of Recommended Accounting Standards No. 5, Accounting for Liabilities of the Federal Government.

**15** A will or clause of a will disposing of property.

[31] The cost of general PP&E **transferred from other Federal entities** shall be the cost recorded by the transferring entity for the PP&E net of accumulated depreciation or amortization. If the receiving entity cannot reasonably ascertain those amounts, the cost of the PP&E shall be its fair value at the time transferred.

[32] The cost of general PP&E acquired through **exchange**[16] shall be the fair value of the PP&E surrendered at the time of exchange.[17] If the fair value of the PP&E acquired is more readily determinable than that of the PP&E surrendered, the cost shall be the fair value of PP&E acquired. If neither fair value is determinable the cost of the PP&E acquired shall be the cost recorded for the PP&E surrendered net of any accumulated depreciation or amortization. Any difference between the net recorded amount of the PP&E surrendered and the cost of the PP&E acquired shall be recognized as a gain or loss. In the event that cash consideration is included in the exchange, the cost of general PP&E acquired shall be increased by the amount of cash consideration surrendered or decreased by the amount of cash consideration received.

[33] The cost of general PP&E acquired through **forfeiture** shall be determined in accordance with Statement of Federal Financial Accounting Standards No. 3, *Accounting for Inventory and Related Property* (SFFAS 3).[18] Amounts recorded for forfeited assets based on SFFAS 3 shall be recognized as the cost of general PP&E when placed into official use.

[34] PP&E shall be recognized when title passes to the acquiring entity or when the PP&E is delivered to the entity or to an agent of the entity.[19] In the case of constructed PP&E, the PP&E shall be recorded as construction work in process until it is placed in service, at which time the balance shall be transferred to general PP&E.

**Expense Recognition**

[35] Depreciation expense is calculated through the systematic and rational allocation of the cost of general PP&E, less its estimated salvage/residual value, over the estimated useful life of the general PP&E. Depreciation expense shall be recognized on all general PP&E[20], except land and land rights of unlimited duration.[21]

- Estimates of useful life of general PP&E must consider factors such as physical wear and tear and technological change (e.g., obsolescence).
- Various methods can be used to compute periodic depreciation expense so long as the method is systematic, rational, and best reflects the use of the PP&E.

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[16] This paragraph applies only to exchanges between a Federal entity and a non-Federal entity. Exchanges between Federal entities shall be accounted for as transfers (See paragraph 31).

[17] If the entity enters into an exchange in which the fair value of the PP&E acquired is less than that of the PP&E surrendered, the PP&E acquired shall be recognized at its cost as described in paragraph 32 and subsequently reduced to its fair value. A loss shall be recognized in an amount equal to the difference between the cost of the PP&E acquired and its fair value.

[18] SFFAS 3 requires that forfeited real and personal property be valued at market value less an allowance for any liens or claims from a third party.

[19] Delivery or constructive delivery shall be based on the terms of the contract regarding shipping and/or delivery. For PP&E acquired by a contractor on behalf of the entity (e.g., the entity will ultimately hold title to the PP&E), PP&E shall also be recognized upon delivery or constructive delivery whether to the contractor for use in performing contract services or to the entity.

[20] Software and land rights, while associated with tangible assets, may be classified as intangible assets by some entities. In this event, they would be subject to amortization rather than depreciation. "Amortization" is applied to intangible assets in the same manner that depreciation is applied to general PP&E--tangible assets.

[21] Land rights that are for a specified period of time shall be depreciated or amortized over that time period.

- Any changes in estimated useful life or salvage/residual value shall be treated prospectively. The change shall be accounted for in the period of the change and future periods. No adjustments shall be made to previously recorded depreciation or amortization.

[36] Depreciation expense shall be accumulated in a contra asset[22] account--accumulated depreciation. Amortization expense shall be accumulated in a contra asset account--accumulated amortization.

[37] Costs which either extend the useful life of existing general PP&E, or enlarge or improve its capacity shall be capitalized and depreciated/amortized over the remaining useful life of the associated general PP&E.

[38] In the period of disposal, retirement, or removal from service, general PP&E shall be removed from the asset accounts along with associated accumulated depreciation/amortization. Any difference between the book value of the PP&E and amounts realized[23] shall be recognized as a gain or a loss in the period that the general PP&E is disposed of, retired, or removed from service.

[39] General PP&E shall be removed from general PP&E accounts along with associated accumulated depreciation/amortization, if prior to disposal, retirement or removal from service, it no longer provides service in the operations of the entity. This could be either because it has suffered damage, becomes obsolete in advance of expectations, or is identified as excess. It shall be recorded in an appropriate asset account at its expected net realizable value. Any difference in the book value of the PP&E and its expected net realizable value shall be recognized as a gain or a loss in the period of adjustment. The expected net realizable value shall be adjusted at the end of each accounting period and any further adjustments in value recognized as a gain or a loss. However, no additional depreciation/amortization shall be taken once such assets are removed from general PP&E in anticipation of disposal, retirement, or removal from service.

**Implementation Guidance**

[40] For existing general PP&E, if historical cost information necessary to comply with the above recognition and measurement provisions has not been maintained, estimates are required. Estimates shall be based on:

- cost of similar assets at the time of acquisition, or
- current cost of similar assets discounted for inflation since the time of acquisition (i.e., deflating current costs to costs at the time of acquisition by general price index).

[41] Accumulated depreciation/amortization shall be recorded based on the estimated cost and the number of years the PP&E has been in use relative to its estimated useful life. Alternatively, the PP&E may be recorded at its estimated net remaining cost[24] and depreciation/amortization charged over the remaining life based on that net remaining cost.

[42] For general PP&E that would be substantially depreciated/amortized had it been recorded upon acquisition based on these standards, materiality and cost-benefit should be weighed heavily in determining estimates. Consideration should be given to:

[22] A contra asset account is an account which partially or wholly offsets an asset account. On financial statements they may be either merged or appear together.

[23] For example, amounts realized may include cash received for scrap materials or fair value of items received in exchange for PP&E removed from service.

[24] *Net remaining cost* is the original cost of the asset less any accumulated depreciation/amortization to date.

- recording only improvements made during the period beyond the initial expected useful life of general PP&E, and
- making an aggregate entry for whole classes of PP&E (e.g., entire facilities rather than a building by building estimate).

[43] In recording existing general PP&E, the difference in amounts added to asset and contra asset accounts shall be credited (or charged) to Net Position of the entity. The amount of the adjustment shall be shown as a "prior period adjustment" in the statement of changes in net position. For published financial statements presenting prior year information, no prior year amounts shall be restated.

[44] In the period that these standards are implemented, disclosure of the adjustments, by major class[25] of PP&E, made to general PP&E and accumulated depreciation/amortization is required.

**Disclosure Requirements**

[45] The following are minimum general PP&E disclosure requirements:

- the cost, associated accumulated depreciation, and book value by major class;
- the estimated useful lives for each major class;
- the method(s) of depreciation for each major class;
- capitalization threshold(s) including any changes in threshold(s) during the period; and
- restrictions on the use or convertability of general PP&E.

## SFFAS 23, *Eliminating the Category National Defense Property, Plant and Equipment*

[9] (f) SFFAS No. 6 is amended by adding the following sentence to paragraph 35 as a separate bulleted line item:

- A composite or group depreciation methodology[26], whereby the costs of PP&E are allocated using the same allocation rate, is permissible.

[25] "Major classes" of general PP&E shall be determined by the entity. Examples of major classes include buildings and structures, furniture and fixtures, equipment, vehicles, and land.

[26] The composite methodology is a method of calculating depreciation that applies a single average rate to a number of heterogeneous assets that have dissimilar characteristics and service lives. The group methodology is a method of calculating depreciations that applies a single, average rate to a number of homogeneous assets having similar characteristics and service lives.

## Appendix D: Letter from Department of Defense Deputy Chief Financial Officer

**OFFICE OF THE UNDER SECRETARY OF DEFENSE**
1 100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

MAR **1 6** 2006

Ms. Wendolyn Comes
Executive Director
Federal Accounting Standards Advisory
Board 441 G. Street, N.W.
Washington, DC 20548

Dear Ms. Comes:

The Department of Defense (DoD) is continuing to take steps to implement its financial management improvement plans and accounting processes. In the course of this process, we have taken a critical look at the Department's business process for the repair of inventories, and the applicability of the Statement of Federal Financial Accounting Standard (SFFAS) No. 3 as it relates to inventory repair. In line with this review, we have also researched comparable commercial processes through available web-based literature as well as through direct contact with commercial firms. Subsequent to consideration of all our findings, we have concluded that the Department's repair process is directly comparable to the private sector process typically referred to as "remanufacturing," and that our reparable carcasses (referred to as "cores" in the private sector) acquired in exchange sales for reparable items are similar, if not the same, as "raw materials" or components used in the remanufacturing process. More importantly, we have come to believe that "inventory repair" suggests a misleading process when viewed in the context of rebuilding worn and used carcasses/cores for the primary purpose of providing rebuilt items for new sales. The following paragraphs elaborate on our findings and conclusions.

Based on commercial sourced information noted above, we found that the remanufacturing process had specific characteristics that were virtually parallel regardless of product or entity (i.e., commercial or DoD). Both remanufacturing companies and the DoD acquire worn carcasses/cores through exchange sales of remanufactured items or newly procured items with financial incentives or credit given for the exchanged cores. Both inspect, disassemble, evaluate, clean, rebuild, refurbish, and restore products to "good-as-new" condition for inclusion as finished goods inventory and for sale to new customers. More importantly, both often enhance products with upgrades which incorporate new technologies, reduce obsolescence, extend useful life, increase safety, and improve reliability.

Regardless of the technical processes, or the definition attached to the process, we believe that certain, fundamental attributes must be considered in the accounting solution when inventory items are repaired:

- First, inventory, by definition, is "held for sale." Since inventory held for sale is typically found on "warehouse shelves," the repair of damaged items in current storage, and the return of those items to the warehouse is a rare or immaterial event.
- Second, since it is rare for on-the-shelve, held-for-sale items to be repaired, we can generally conclude that any large-scale inventory item repair process, whether undertaken by commercial firms or the DoD, will always be a "source-of-supply" process which provides rebuilt or remanufactured items for new sales.
- Third, it can also be concluded that rebuild processes for resale will always involve some form of market-based or incentive-based business process which provide for the return of worn or used carcasses/cores for rebuild. Carcasses/cores then become similar to raw material and, more importantly, should reflect the cost to obtain them.
- Finally, regardless of the name attached to the refurbishment process, i.e., "repair," "rebuild," "remanufacture," or other, a fundamental rule of accounting states that "all costs incurred to place assets into use, or to get inventory items ready for sale, should be capitalized into the cost of the asset."

Despite these attributes, paragraphs 32 and 33 (Inventory Held for Repair) of SFFAS No. 3 provide that entities should charge or credit the difference between actual and estimated repair costs to current period expense. However, when the process its correctly viewed as a process undertaken with the intent of rebuilding returned worn and used cores for subsequent resale, we believe that limiting the application of capitalized repair to estimated repair is not only inappropriate but, in fact, distorts the matching of cost of sales and revenue at time of sale.

Reconciliation of the historical cost requirements in Statement No. 3 with the requirements set forth in paragraphs 32 and 33 are problematic. The SFFAS No. 3 provides that entities value Inventory Held for Sale at historical cost. Paragraph 21 defines historical cost to "include all appropriate purchase, transportation and production costs incurred to bring items to their current condition and location." In addition, commercial accounting principles for inventory cost have always been guided by a fundamental rule of capitalization as stated in Accounting Research Bulletin 43, Chapter 4, Paragraph 5, as follows: "The primary basis of accounting for inventories is cost, which has been defined generally as the price paid or consideration given to acquire an asset." When applied to inventories, cost means, in principle, the "sum of all applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location." Paragraphs 32 and 33 of Statement 3, however, impose restrictions on both cost capitalization and the value of carcasses. Paragraphs 32 and 33 require that regardless of the level of effort or cost incurred to rebuild items for resale, rebuild costs must be expensed as period costs if they exceed estimated repair. Secondly, paragraphs 32 and 33 dictate that carcass costs are not independent, but rather are a. function of the cost of related serviceable items less estimated repair. This principle ties the value of carcasses to the procurement cost of serviceable items and thus, subjects carcasses to a continuing revaluation unrelated to their cost.

Each year, the Department, through incentive exchange sales from our revolving funds or through directed returns, processes thousands of reparable item returns (i.e., carcasses) for subsequent repair/rebuild. Similarly, thousands of commercial firms obtain cores through exchange sales or through available market purchases for remanufacturing. The objectives of this business process in both instances are to: (1) establish an alternative source of supply that utilizes the main component of the items being rebuilt, and (2) repair/rebuild/remanufacture the carcasses or cores for subsequent resale. From an accounting perspective, we have to believe that commercial firms can only be capitalizing such costs into the cost of the products sold in lieu of period repair expense. It appears clear that reporting repair expenses for large-scale remanufacturing and resale operations would be in conflict with accepted accounting principles, would understate their inventory and cost of goods sold, and would mismatch costs and revenue at the time of sale. Based on these conclusions, and those attributes we summarized previously, the following and remaining paragraphs state our proposals for SFFAS No. 3 inventory repair principles.

We propose that Inventory Held for Repair be revisited in terms of the prevailing business process. As stated in our first and second attributes above, we believe that "inventory repair" per se is a rare event that, if viewed in terms of overall principles, will reveal source-of-supply and resale objectives.

We propose that "repair expense" be subjected to a critical and theoretical review in terms of "inventory repair." Textbook examples of repair expense versus repair capitalization typically make reference to real property and fixed assets. Capitalized repair is matched to revenue through depreciation charges. Since inventory is not depreciated, capitalized repair can, therefore, only match revenue as a part of cost of goods sold. We believe this is the correct answer; however, there is little, if any, accounting guidance in this area.

If it is concluded that large-scale inventory repair is undertaken primarily for the purpose of selling rebuilt/remanufactured items, we then propose that the question of cost capitalization be subjected to the general requirement to capitalize all costs to bring inventory items to the point of sale. We believe this issue should also be subjected to the question of "asset value or life added" versus the objective of "resale." That is, it can be argued that if repair does not add substantial value or life to an inventory item, then it should be expensed. We believe that the sale objective and the matching of cost of goods sold should be the prevailing factor.

If it is concluded that inventory repair is a rebuild/resell process, we then propose that the valuation of carcasses/cores be independent of the cost of items held for sale. We believe that carcasses should be valued at "cost."

These proposals, depending on your consideration or conclusions, could bring to bear additional changes or findings. For example, recording carcasses at cost a and rebuilt items at full cost could negate the need for the allowance method or direct method and potentially revise the implementation adjustments currently stated in Paragraph 34 (i.e., reporting entities which accrued amounts for repair expense under previous standards based on estimated repair costs may be required to make subsequent adjustments for carcasses held at cost without an allowance). Paragraph 17(3) could be revised to include remanufactured components. In addition, it should be kept in mind that this letter addresses only inventory for sale (or repaired for ultimate resale). There are variations of repair and spare parts management in some industries (airlines for example) that repair or rebuild items for internal recycling only. These items, we believe, are accounted for as depreciable assets.

My staff will be pleased to work with you or anyone you deem to be appropriate on the FASAB staff on this issue and will provide any assistance or information that you determine to be necessary. Questions or requirements for additional information can be directed to my point of contact, Mr. Wayne Hudson. Mr. Hudson can be reached by phone at (703) 697-8281 or by e-mail at wayne.hudson@osd.mil.

Sincerely,

Teresa McKay
Deputy Chief Financial Officer

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